



# Perspectives

ARBUTHNOT BANKING GROUP PLC

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## The Autumn Statement: the economic outlook darkens

### Introduction: the economic forecasts

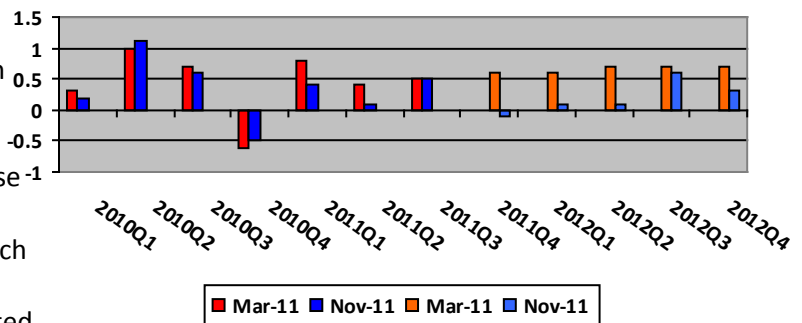
The Office for Budget Responsibility (OBR) significantly downgraded their GDP forecasts in their latest *Economic and fiscal outlook*, which accompanied last week's Autumn Statement.<sup>1,2</sup>

Chart 1 shows the quarterly GDP data for the actuals (up to 2011Q3) and for the projections (2011Q4-2012Q4) from the OBR's March and November forecasts. The main points to note are:

- The OBR is now forecasting GDP growth of 0.9% for 2011 (1.7% in March) and 0.7% for 2012 (2.5% in March). The quarterly data shown below reflect these overall forecasts.
- The economy underperformed the March 2011 forecast almost immediately after the forecast was made. The OBR expected an increase of 0.8% in 2011Q1 – but actual growth was only 0.4%. Similarly growth in 2011Q2 undershot expectations, partly because of the Royal Wedding. March's projections were clearly far too optimistic.
- The OBR is now expecting a small (0.1%) quarterly fall in 2011Q4, followed by extraordinarily weak growth (0.1%) in the first two quarters of 2012. Such figures skirt a technical recession, defined as two consecutive quarters of falling output. Growth recovers in 2012H2.

- The OBR strongly cautioned that there were risks to their November forecasts and there was a one in three chance that the UK would fall back into recession over the next three quarters.
- The OBR's gloomy GDP forecasts are much in line with the most recent OECD forecasts, which suggested that UK growth would be 0.9% in 2011 and 0.5% in 2012.<sup>3</sup>

**Chart 1 OBR's short-term GDP forecast (QOQ, %), March & November 2011**



Sources: OBR, *Economic and fiscal outlook*, March 2011; OBR, *Economic and fiscal outlook*, November 2011; actuals up to 2011Q3.

Table 1 and chart 2 show the OBR's short-term and medium-term forecasts for GDP and the main components. The main points to note are:

- The main reason for the growth undershoot in 2011 has been the drop in household consumption, which accounts for over 60% of GDP. The OBR attributed this to the squeeze on real incomes caused by prices inflation outstripping earnings growth. Provided commodity prices over the forecast period show little increase, or even fall, this effect can be expected to partly reverse and underpin some resumption of growth from 2012H2 onwards. The biggest hope in a rather bleak forecast is for a fall in commodity prices.
- The OBR projects a strong pick-up in growth rates in 2015 and 2016, which may be over-optimistic. If they are, then the Chancellor's fiscal mandate and supplementary debt/GDP target look even more vulnerable than they are portrayed below. This is further discussed below.
- General Government Final Consumption (central government and local authority current spending) contributed to growth in 2011, contrary to claims by opposition politicians. It will however turn negative in 2012 and act as a drag on growth up to 2016, the end of the forecast period. The cuts in public spending in the final two years, falling outside the 2010 *Spending Review* period, are especially marked and will be further discussed below.<sup>4</sup>
- Business investment significantly underperformed in 2011, as we expected. The forecasts still look over-optimistic despite the growth downgrades, given the tepid growth outlook for much of the period.
- The net trade performance was very creditable in 2011H1 but given the weakness in the Eurozone, the UK's major export market, will be less positive in 2012. The remainder of the forecast, which has been significantly revised down, looks plausible.
- CPI inflation is expected to fall to target in 2013. This seems reasonable.

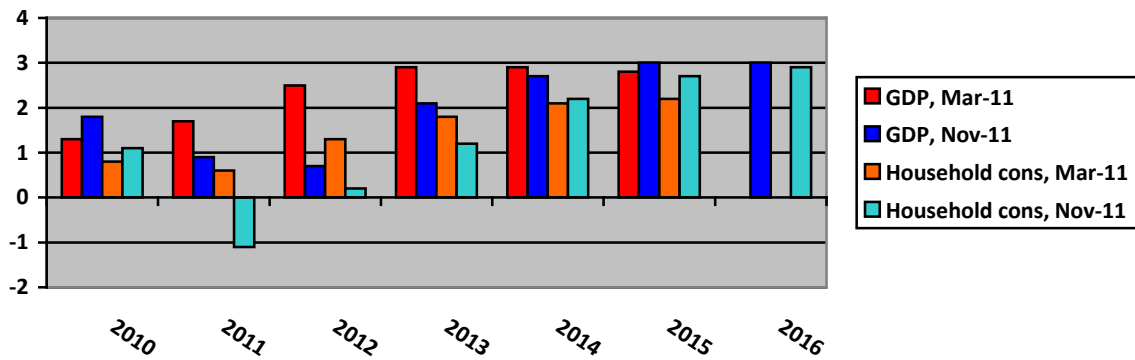
**Table 1 The OBR's economic forecasts, YOY changes (%)**

	2010	2011	2012	2013	2014	2015	2016
<b>GDP:</b>							
March 2011	1.3	1.7	2.5	2.9	2.9	2.8	Na
November 2011	1.8	0.9	0.7	2.1	2.7	3.0	3.0
November minus March forecast	0.5	-0.8	-1.8	-0.8	-0.2	0.2	Na
<b>Household consumption:</b>							
March 2011	0.8	0.6	1.3	1.8	2.1	2.2	Na
November 2011	1.1	-1.1	0.2	1.2	2.2	2.7	2.9
November minus March forecast	0.3	-1.7	-1.1	-0.6	0.1	0.5	Na
<b>GGFC:</b>							
March 2011	1.0	0.8	-1.2	-1.8	-2.4	-1.8	Na
November 2011	1.5	2.2	-0.1	-1.6	-2.3	-3.2	-3.5
November minus March forecast	0.5	1.4	1.1	0.2	0.1	-1.4	Na
<b>Business investment:</b>							
March 2011	2.5	6.7	8.9	10.6	10.2	7.8	Na
November 2011	0.8	-0.8	7.7	8.9	9.4	12.6	12.4
November minus March forecast	-1.7	-7.5	-1.2	-1.7	-0.8	4.8	Na
<b>Net trade+</b>							
March 2011	-0.9	0.7	1.0	0.7	0.6	0.5	Na
November 2011	-0.8	1.2	0.3	0.6	0.3	0.2	0.1
November minus March forecast	0.1	0.5	-0.7	-0.1	-0.3	-0.3	Na
<b>CPI:</b>							
March 2011	3.3	4.2	2.5	2.0	2.0	2.0	Na
November 2011	3.4	4.5	2.7	2.1	2.0	2.0	2.0

Sources: OBR, *Economic and fiscal outlook*, March 2011, OBR, *Economic and fiscal outlook*, November 2011. GGFC stands for General Government Final Consumption.

+ For net trade: the contribution to GDP growth, percentage points.

**Chart 2 The OBR's forecasts for GDP and household consumption, YOY changes (%)**

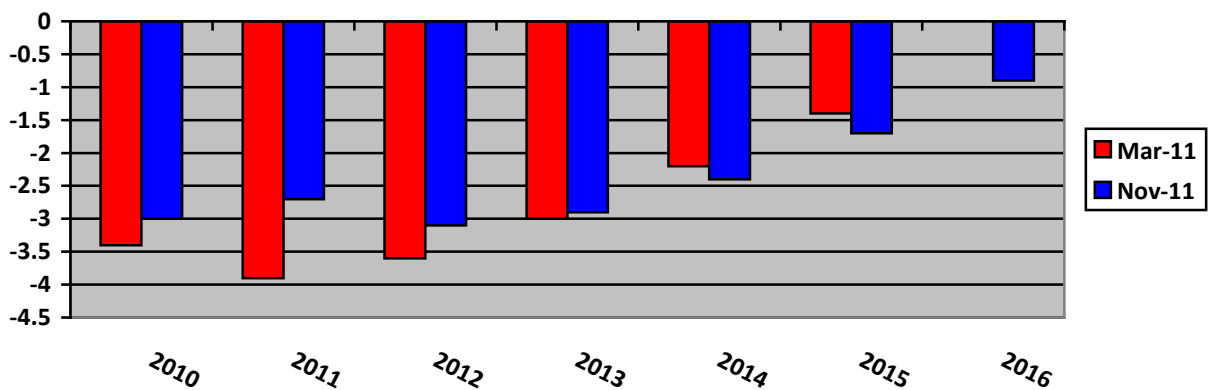


Sources: OBR, *Economic and fiscal outlook*, March 2011; OBR, *Economic and fiscal outlook*, November 2011.

*The economic forecasts: further considerations*

It is important to note that the OBR revised two key inputs underlying the forecasts. The first input was the “output gap”, the difference between actual GDP and “potential” GDP. The OBR revised down its estimate of the 2011 output gap to 2.7% from nearly 4% in March (see chart 3). This implies that there was less “spare capacity” in the economy to support growth going forward than previously thought. It also implies that there was more damage done to the UK’s productive capacity by the policies pursued up to 2007 than previously estimated. Given the OBR’s approach to forecasting, this downward revision means that it must cut its forecast for the level GDP will reach in 2015 from its last (March) forecast.

**Chart 3 The OBR's estimates of the output gap (% of GDP)**



Sources: OBR, *Economic and fiscal outlook*, March 2011, OBR, *Economic and fiscal outlook*, November 2011

There are important implications for the public finances. Firstly, less growth means weaker finances, other things being equal. Secondly, because output gap estimates have shrunk, the OBR now has to attribute less of the public finance deficit to cyclical factors and, concomitantly, more to structural (cyclically-adjusted) factors. Less of the deficit will disappear as the economy grows. There will therefore have to be either additional spending cuts or higher taxes or both to tackle the structural deficit. The Government's fiscal mandate (see below) is couched in terms of the cyclically-adjusted current budget (CACB) balance and is therefore sensitive to the

OBR's assumptions about the output gap. This is unfortunate, if not misguided.

The second input was the potential (r trend) output growth rate, which is the rate at which the economy can grow at unchanged capacity utilisation rates. As table 2 shows the OBR has been obliged to revise down potential output growth for 2012 and 2013, reflecting the poor productivity performance in recent quarters. This downgrade inevitably undermines the growth rates achievable in these years. But thereafter good growth is resumed, reflecting the OBR's view that productivity growth will recover.

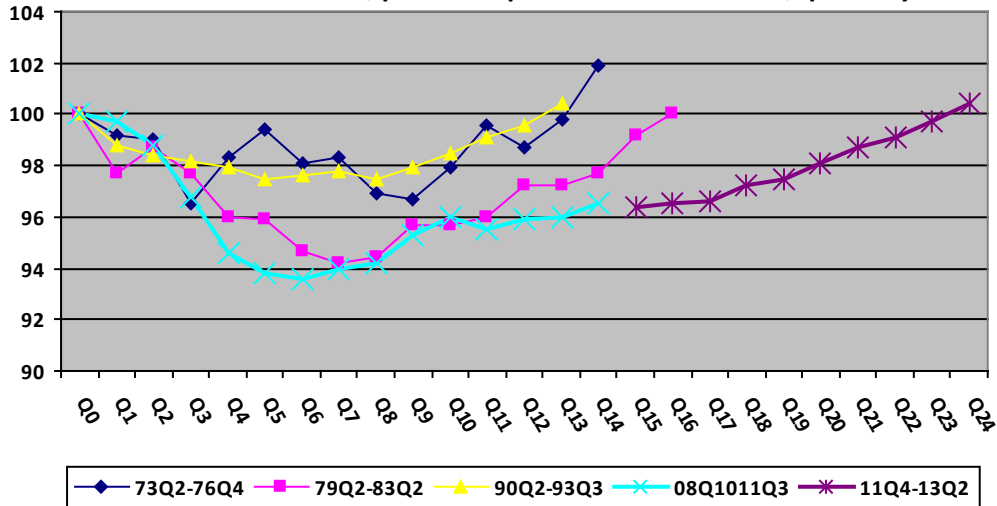
**Table 2 Potential output growth forecasts (annualised growth rates, %)**

	Potential productivity	Potential average hours	Potential employment rate	Potential population	Potential output
March 2011:					
2010Q3-2013Q4	2.0	-0.2	-0.15	0.7	2.35
2014Q1-2016Q1	2.0	-0.2	-0.2	0.5	2.1
November 2011:					
2012	1.0	-0.2	-0.3	0.7	1.2
2013	1.6	-0.2	-0.2	0.7	2.0
2014	2.1	-0.2	-0.2	0.5	2.3
2015	2.2	-0.2	-0.2	0.5	2.3
2016	2.2	-0.2	-0.2	0.5	2.3

Sources: OBR, *Economic and fiscal outlook*, March 2011; OBR, *Economic and fiscal outlook*, November 2011. NB productivity = output per hour.

Chart 4 below gives our updated assessment of when the British economy will attain its previous GDP peak (2008Q1). After recovering quite well up to 2010Q3, the economy has struggled since and, according to the OBR, will struggle until 2012H2. On our interpretation of the OBR's November forecasts, the 2008Q1 peak level will not be attained until 2014Q1 (quarter 24), nearly 6 years after the beginning of the recession. GDP is still nearly 4% below its 2008Q1 peak. There is no doubt that the current recession is quite the worst post-war recession.

**Chart 4 Post-war recessions, peak GDP prior to recession =100, quarterly data**



Sources: (i) ONS database for back GDP data in constant prices; (ii) OBR, *Economic and fiscal outlook*, November 2011; (iii) author's calculations. Q0 is the peak GDP prior to the recession.

### *The storm outside: the Eurozone crisis*

The Autumn Statement was overshadowed by developments in the Eurozone. Tellingly the OBR's forecasts were based on the assumption that the Eurozone would muddle through and not implode. The OBR said with admirable constraint "...the possibility of a more disorderly outcome represents a significant risk on the downside to our forecast, but one that is impossible to quantify in a meaningful way given the range of potential outcomes." There could therefore be a "much worse outcome" for Britain. The OBR's approach is quite understandable and it is difficult to see what else they could have done under the circumstances although whether there would indeed be a "much worse outcome" in the medium-term, as opposed to short-term disruption and shock, is questionable.

The OBR identified four main channels through which an intensification of the Eurozone crisis could affect the UK economy:<sup>5</sup>

- Weaker trade: the euro area accounts for a significant share of UK exports, so additional weakness in euro area demand would lead to lower UK export growth.
- Tighter credit: recent developments have increased the funding costs faced by European and UK banks.
- Government borrowing costs: UK gilt yields are currently at historically low levels, which is likely in part to reflect market perceptions that UK gilts are low risk ("safe haven") relative to many euro area countries. But it is not clear whether a further deepening of the euro area crisis would reduce gilt yields or increase them.
- Financial system impairment: a more serious escalation of the crisis, such as a disorderly default on sovereign debt, could put the global financial system under severe strain leading to tighter credit conditions, further depressing world output and trade. The OBR said "...given the range of potential outcomes from such an extreme event, it is not possible to quantify this risk in any meaningful way."

Sir Mervyn King was so pessimistic in his press conference on the latest *Financial Stability Report* on Thursday that any remnant of optimism about our near-term economic prospects was extinguished. The Eurozone debt crisis had placed Britain, and its banking system, in an "extraordinarily dangerous" situation. The Governor accordingly outlined the Financial Policy Committee's main recommendations for strengthening banks:<sup>6</sup>

- ...if earnings are insufficient to build capital levels further, banks should limit distributions and give serious consideration to raising external capital in the coming months.
- ...the Committee reiterates its advice to the FSA to encourage banks to improve the resilience of their balance sheets without exacerbating market fragility or reducing lending to the real economy.
- ...the Committee recommends that the FSA encourages banks to disclose their leverage ratios, as defined in the Basel III agreement, as part of their regular reporting not later than the beginning of 2013.

### *The public finances*

As already discussed the poor GDP outlook has negative implications for the public finances. And, as we have also already discussed, the OBR's downward revisions to the "output gap" for 2011 have pushed up the structural deficits and therefore made it harder for the Chancellor to meet his fiscal mandate. Table 3 shows the revised forecasts.

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016
Cyclically-adjusted current budget, % of GDP:							
March 2011	-4.6	-3.2	-2.0	-0.6	<b><u>+0.4</u></b>	+0.8	Na
November 2011	-4.5	-4.6	-3.9	-2.7	-1.6	-0.6	<b><u>+0.5</u></b>
November minus March forecast	0.1	-1.4	-1.9	-2.1	-2.0	-1.4	Na
Public Sector Net Borrowing (PSNB, £bn):							
March 2011	145.9	122	101	70	46	29	Na
November 2011	137.1	127	120	100	79	53	24
November minus March forecast	-8.8	5	19	30	33	24	Na
Cumulative increase	Na	5	24	54	87	111	Na
Public Sector Net Debt (£bn), end year:							
March 2011	909	1046	1164	1251	1314	1359	Na
November 2011	905	1044	1182	1300	1397	1470	1515
November minus March forecast	-4	-2	18	49	83	111	Na
Public Sector Net Debt (% of GDP), end year:							
March 2011	60.3	66.1	69.7	70.9	<b><u>70.5</u></b>	69.1	Na
November 2011	60.5	67.5	73.3	76.6	78.0	<b><u>77.7</u></b>	75.8
November minus March forecast	0.2	1.4	3.6	5.7	7.5	8.6	Na

Sources: (i) OBR, *Economic and Fiscal Outlook*, March 2011; (ii) OBR, *Economic and fiscal outlook*, November 2011. The underlined numbers in bold indicate the meeting of the fiscal mandate and the supplementary target.

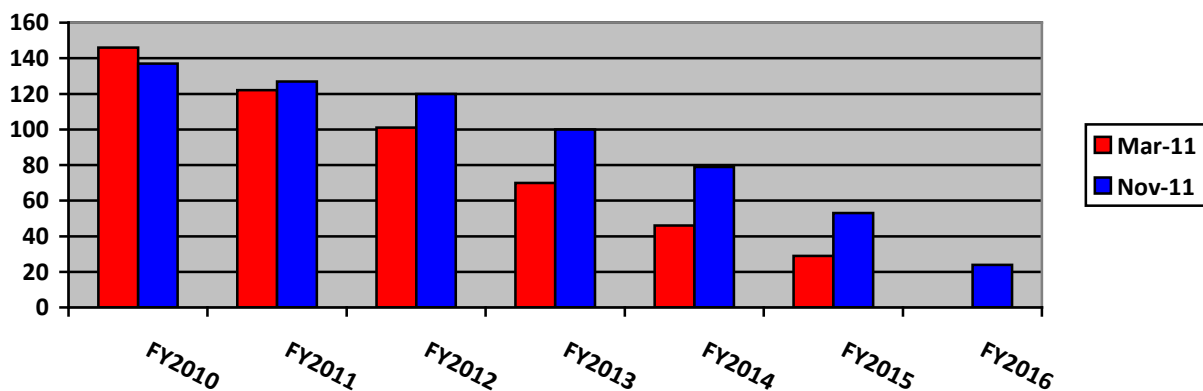
The main conclusions that can be drawn from these revised forecasts are:

- £111bn more of borrowing is forecast for the period FY2011 to FY2015. The borrowing numbers are the ones the markets focus on (see chart 5).
- The “fiscal mandate”, whereby the cyclically-adjusted (structural) current budget (CACB) should be in balance by the end of the rolling, 5-year forecast period (currently FY2016), is now deemed to be met by FY2016 rather than by FY2014 (as in March). But this is only met by projecting buoyant GDP growth in 2015 and 2016 (see above) and big cuts in public spending in FY2015 and FY2016 (see below). There is a reasonable chance that this

combination will not be achieved and the fiscal mandate will be missed.

- Public sector debt is forecast to be £111bn higher in November than in March.
- The supplementary target, whereby the PSND/GDP ratio falls at the fixed date of FY2015, is now deemed to be met in FY2015 rather than in FY2014 (as in March). As with the fiscal mandate, meeting this target depends on good GDP growth and big spending cuts. There has to be good chance that it will also be missed.

Chart 5 The OBR’s projections for Public Sector Net Borrowing (£bn)



Sources: OBR, *Economic and fiscal outlook*, March 2011; OBR, *Economic and fiscal outlook*, November 2011.

*Policy changes: further spending cuts*

The Autumn Statement, a Pre-Budget report in all but name, contained several tax and spending decisions that affected overall borrowing totals. It was broadly neutral for the years FY2011 to FY2014 and significantly tightening for FY2015 and FY2016. The details are shown in the annex table 1.

Table 5 shows the key components of the OBR's forecasts for borrowing. The main features of the forecasts are:

- Between the March and November forecasts Total Managed Expenditure (TME, total spending) was revised down modestly until FY2014, and down more sharply in FY2015. Within the total, Social Security benefits (uprated by 5.2%) and public service pension payments were increased. But there were reductions in investment and debt interest payments, the latter reflecting lower gilt rates and short-term rates assumptions. The savings from lower market rates was a very significant contributor to the lower spending data. If market rates were to rise, then these savings would be reversed. A breakdown of November's estimates for TME is shown in annex table 2.
- The Autumn Statement measures for spending were small with the exception of FY2015 (a cut of £8.3bn) and FY2016 (a cut of £15.1bn). These years are outside the 2010 *Spending Review* and detailed departmental breakdowns are unavailable.<sup>7</sup> It is now quite clear that the Government's original (June 2010) strategy of eliminating the structural budget deficit by the next election (2015), and in a position to offer tax cuts, is now defunct. Austerity is now pencilled in for FY2015 and FY2016, beyond the next election, at the very minimum.
- Between the March and November forecasts receipts were revised down significantly reflecting the weaker income forecasts and lower interest rates assumptions.
- The Autumn Statement measures for receipts were modest.

**Table 5 Components of public sector borrowing, £bn**

	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016
<b>Total Managed Expenditure:</b>						
March 2011	710.4	720.2	730.1	743.6	763.8	Na
November 2011	702.6	714.5	723.1	736.4	746.6	758.7
November minus March	-7.8	-5.7	-7.0	-7.3	-17.2	Na
Autumn Statement measures, spending	0	-0.2	0.3	-0.1	-8.3	-15.1
Ditto: reductions in borrowing	0	0.2	-0.3	0.1	8.3	15.1
<b>Receipts:</b>						
March 2011	588.6	619.7	660.3	697.5	734.5	Na
November 2011	575.5	594.4	623.6	657.4	693.5	735.2
Change	-13.1	-25.3	-36.7	-40.0	-41.0	Na
Autumn Statement measures, receipts	0	-0.3	0.1	0.1	0	0
<b>Borrowing:</b>						
March 2011	122	101	70	46	29	Na
November 2011	127	120	100	79	53	24
Change	5	19	30	33	24	Na
Autumn Statement measures, net reductions in borrowing	0	0	0	0	8	15

Source: OBR, *Economic and fiscal outlook*, November 2011. There are rounding errors in the table.  
 Note for borrowing figures: + = reduces borrowing; - = increases borrowing.

Reflecting the Government's decision to pencil in further spending cuts in FY2015 and FY2016, the OBR revised the total reduction in General Government Employment (GGE) to around 710,000 between 2011Q1 and 2017Q1 compared with 400,000 between 2011Q1 and 2016Q1 in the March 2011 forecast.<sup>8</sup>

*Policies for growth: help for business*

Given the enormity of the difficulties facing the country, the Government's growth policies are still far from being sufficiently radical. Much more needs to be done to strengthen the supply side and support business. As we have written before, a few sacred cows need to be slaughtered and vested interests challenged.<sup>9</sup>

Nevertheless there were measures in the Autumn Statement, which should be helpful. They included:<sup>10,11</sup>

- Credit easing: which is intended to increase the supply of credit and increase for credit demand (via lower interest rates) and create a market that better supports small business loans. The Government will introduce a National Loan Guarantee Scheme, with up to £20bn of government guarantees for bank lending, allowing banks to offer lower cost lending to business. Further details are awaited.
- Infrastructure: the Government will use the savings from current spending (including public sector pay restraint) to fund an extra £6.3bn of additional spending (£1.3bn was announced in autumn, so a net increase of £5bn) over the next three years. This should make the planned cuts to investment less sharp. The Government also announced commitments (to £5bn) in the next Spending Review period (after FY2014), as part of the National Infrastructure Plan.<sup>12</sup>

It has approached UK pension funds to support infrastructural investment, targeting up to £20bn of investment.

- Extra support for education.
- Further reform of employment legislation.
- Regional growth: including expanded and extended Enterprise Zones and an increase of £1bn in the Regional Growth Fund.
- Manufacturing and exports: including increased investment through UKTI, and part compensation for energy intensive users for the high costs of "green energy."

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## References

1. OBR, *Economic and Fiscal Outlook*, Cm8218, November 2011.
2. HM Treasury, Autumn Statement 2011, Cm8231, November 2011.
3. OECD, "OECD calls for urgent action to boost ailing global economy", 28 November 2011. The OECD forecast a recession for the Eurozone with falling output in both 2011Q4 (-1.0%) and 2012Q2 (-0.4%). Growth in 2012 would be just 0.2%.
4. HM Treasury, *Spending Review 2010*, Cm7942, October 2010.
5. OBR, *Economic and Fiscal Outlook*, Cm8218, November 2011.
6. Bank of England, Financial Stability Report press conference, opening remarks by the Governor, 1 December 2011.
7. HM Treasury, *Spending Review 2010*, Cm7942, October 2010.
8. OBR, *Economic and Fiscal Outlook*, Cm8218, November 2011.
9. Ruth Lea, "The Autumn Statement: weaker growth calls for radical growth policies", Arbuthnot Banking Group, 21 November 2011.
10. Helen Miller, "Policies for growth", IFS, November 2011.
11. HM Treasury, Autumn Statement 2011, Cm8231, November 2011.
12. HM Treasury and Infrastructure UK, *National Infrastructure Plan 2011*, November 2011.

## Annex

**Table 1 Autumn Statement policy decisions (selected only), £m**

	Head	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016
Measures announced since Budget 2011:							
VAT: low value consignment relief	Tax	0	+90	+95	+95	+100	+100
<b>Tax measures:</b>							
Fuel duty: delay Jan 2012 increase to August & cancel August 2012 increase	Tax	-375	-975	-825	-850	-875	-925
Asset-backed pension contributions: tax treatment	Tax	+340	+450	+450	+450	+450	+450
Bank levy, increase to 0.088%, from Jan 2012	Tax	0	+280	+310	+310	+315	+325
Total tax policy decisions	Tax	-35	-305	+145	+130	+20	+15
<b>Spending measures:</b>							
Changes to current spending	Spend	0	+910	+1175	+1735	+8290	+15105
Changes to capital spending	Spend	0	-660	-1455	-1645	0	0
Total spending policy decisions	Spend	0	+250	-280	+90	+8290	+15105
Of which current spending savings:							
Child Tax Credit: remove over-indexation	Spend	0	+975	+955	+1020	+995	+995
Working Families Tax Credit	Spend	0	+265	+290	+275	+275	+280

Public sector pay restraint	Spend	0	+75	+600	+1075	See note 2	See note 2
ODA: adjusting to meet 0.7% GNI target	Spend	0	+380	+265	+525	See note 2	See note 2
Of which additional current spending:							
Youth contract	Spend	0	-365	-310	-265	See note 2	See note 2
Early years childcare	Spend	0	-85	-240	-455	See note 2	See note 2
Rail fares	Spend	0	-105	-105	-135	See note 2	See note 2
Carbon price floor: energy intensive industries	Spend	0	0	-40	-60	See note 2	See note 2
Of which capital spending:							
New funding for infrastructure	Spend	0	-760	-1785	-2145	See note 2	See note 2
Reserve re-profiling	Spend	0	+100	+330	+500	See note 2	See note 2
<b>Total policy decisions</b>		-35	-55	-135	+220	+8310	+15120

Source: HM Treasury, Autumn Statement 2011, Cm8231, November 2011.

Note 1: + = reduces borrowing; - = increases borrowing.

Note 2: spending measures do not affect borrowing in FY2015 and FY2016 as they fall within the TME assumption.

**Table 2 Total Managed Expenditure, Autumn Statement, £bn**

	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016
Current expenditure:						
Resource AME	310.3	321.9	328.8	342.8	356.9	368.6
Resource DEL	342.1	344.8	348.9	347.4	344.0+	343.3+
Total	652.4	666.7	677.7	690.2	701.0	711.9
Capital expenditure:						
Capital AME	7.0	4.6	4.7	4.3	3.2	2.6
Capital DEL	44.2	43.3	40.7	41.9	42.5+	44.2+
Total	50.2	47.9	45.4	46.2	45.7	46.8
Total TME	702.6	714.5	723.1	736.4	746.6	758.7

Source: HM Treasury, Autumn Statement 2011, Cm8231, November 2011.

TME = Annually Managed Expenditure (AME) + Departmental Expenditure Limits (DELs). + = implied figures assuming unchanged policy